UNITED
NATIONS

E

Economic and Social Council

Distr.
GENERAL

E/C.10/1991/4
12 February 1991

ORIGINAL: ENGLISH

COMMISSION ON TRANSNATIONAL CORPORATIONS
Seventeenth session
10-19 April 1991
Item 5 (a) of the provisional agenda*

ROLE OF TRANSNATIONAL CORPORATIONS IN SERVICES, INCLUDING TRANSNATIONAL BANKS: ROLE OF TRANSNATIONAL BANKS

Transnational banks and the external indebtedness of developing countries

Report of the Secretary-General

SUMMARY

The debt of developing countries to transnational banks has shown a downward trend in recent years. This, however, does not offer any basis for complacency, for several reasons: the prices of the debt instruments on the secondary markets have continued to decline; their debt-servicing capacity has not improved; and negative transfers from transnational banks to highly indebted countries have increased.

The significant reduction in the stock of the debt of developing countries to transnational banks has been facilitated by a variety of regulatory adjustments, including capital adequacy guidelines, the accounting and tax treatment of loan-loss reserves and the accounting and tax treatment of debt-restructuring instruments. This report reviews the modifications introduced in several creditor countries and examines their implications for the incentives of transnational banks to participate in debt-reduction efforts and/or grant new loans as a means to provide cash-flow relief. Some areas for improvements in regulatory frameworks are pointed out in the context of discussion of adjustments in each creditor country. The report also suggests some general areas for further reforms. Those concern

* E/C.10/1991/1.

modifications in risk-weighted capital guidelines, tax deductibility of discounted asset sales, differentiated accounting treatment of loans to developing countries and accounting rules for banks which do not agree to participate in debt reduction efforts. The report points to the need for closer coordination among creditor countries in formulating regulatory policies to facilitate debt-reduction and a greater commitment on the part of political authorities in creditor countries to ensure that transnational banks respond positively to the incentives offered through regulatory adjustments.

CONTENTS

	Paragraphs	Page
INTRODUCTION	1 - 2	4
I. TRANSNATIONAL BANKS AND THE EXTERNAL INDEBTEDNESS OF DEVELOPING COUNTRIES: AN UPDATE	3 - 4	4
II. ACCOUNTING, REGULATORY AND TAX ADJUSTMENTS IN CREDITOR COUNTRIES	5 - 57	6
A. Risk-weighted capital adequacy guidelines	6 - 14	6
B. Treatment of loan-loss reserves	15 - 21	9
C. Treatment of debt-restructuring instruments	22 - 57	11
III. SUGGESTIONS FOR FURTHER ACTION	58 - 66	19
A. Risk-weighted capital guidelines	59	19
B. Tax deductibility of discounted asset sales	60 - 61	20
C. Distinction between purposes of credit	62 - 63	21
D. Accounting penalties for free-riding banks	64 - 65	21
E. Coordination	66	21
CONCLUDING OBSERVATIONS	67 - 70	22

Tables

1. Commercial bank claims on highly indebted developing countries 5

2. Tax and accounting treatment of loan-loss reserves 10

READEX FICHE

INTRODUCTION

1. At its sixteenth session, the Commission on Transnational Corporations adopted a resolution requesting an updated report on the role of transnational banks related to the external indebtedness of developing countries, giving particular attention to the obstacles and problems that transnational banks face in debt reduction. 1/ The present report is in response to that request.

2. In a report submitted to the Commission at its sixteenth session, it was observed that the announcement of the Brady Plan in March 1989 marked a watershed in the perception of the role of transnational banks in the international debt problem. 2/ It represented a shift of emphasis from the maintenance of the stream of debt-servicing payments to debt reduction. It also recognized explicitly the need for actions by creditor country Governments to reduce accounting, regulatory and tax impediments to debt reduction. Taking into account this background and the resolution noted above, the present report provides an update on the indebtedness of developing countries to transnational banks, reviews the recent changes implemented by creditor countries in accounting, regulatory and tax practices which impinge on the role of transnational banks in debt reduction, and suggests several areas for further action.

I. TRANSNATIONAL BANKS AND THE EXTERNAL INDEBTEDNESS OF DEVELOPING COUNTRIES: AN UPDATE

3. The debt of developing countries to transnational banks has shown a clear downward trend in recent years. Between 1987 and the first quarter of 1990, commercial bank claims on all developing countries declined from $650 billion to $617 billion. Of particular interest in the context of this report is the situation of developing countries with severe debt problems. As can be seen from the data presented in table 1, the claims of commercial banks on this group of countries have declined significantly and consistently over the period 1987 to 1990.

4. In spite of this reduction, there are several considerations which provide a compelling logic against any complacency towards the debt problem:

(a) The debt overhang problem has not abated for most countries. One clear piece of evidence is the continuing decline in the secondary market prices of developing country debt. The weighted average price declined from 71 cents per dollar at the end of 1985 to about 34 cents per dollar in November 1990. 3/ The magnitude of decline has, of course, been sharper for some countries (e.g., Argentina and Brazil) than for others (e.g., Mexico and Venezuela). One notable exception is Chile, the market price of whose debt has increased to 73 per cent of face value;

(b) Only five debtor countries (Costa Rica, Mexico, Morocco, the Philippines and Venezuela) have succeeded in concluding debt-restructuring agreements with transnational banks in the framework of the Brady Plan. A combination of moral suasion, active marketing by the bank advisory committees and regulatory

adjustments by creditor countries was required in order to achieve the full participation of transnational banks in protracted negotiation processes. Considerable uncertainty remains regarding similar agreements for other countries, particularly those where the absolute volume of bank debt is modest and where transnational banks have little long-term business interests;

Table 1. Commercial bank claims on highly indebted developing countries

(Millions of dollars)

Country	1987	1988	1989	1990 a/
Argentina	35 252	37 627	32 367	31 096
Bolivia	726	566	353	327
Brazil	81 004	75 975	70 851	68 025
Chile	12 870	10 936	9 061	8 682
Congo	1 510	1 238	1 085	1 020
Costa Rica	1 382	1 264	1 084	1 002
Cote d'Ivoire	3 666	3 364	3 302	6 413
Egypt	7 562	6 741	6 589	6 413
Ecuador	5 066	4 890	4 582	4 295
Honduras	517	487	412	376
Mexico	75 845	71 499	70 158	55 567
Morocco	5 649	5 077	5 174	5 175
Nigeria	10 687	8 906	7 443	7 502
Peru	5 052	4 520	4 068	3 973
Philippines	14 354	12 329	9 640	9 012
Senegal	897	802	502	439
Uruguay	2 115	3 299	2 037	2 091
Venezuela	25 023	25 565	24 132	22 757
Total	289 177	275 085	252 840	234 165

Source: Bank for International Settlements, International Banking and Financial Market Developments, various issues.

a/ First quarter.

(c) The reluctance of banks to provide new money or even maintain exposure has led to shrinking net flows and negative net transfers. Negative net transfers because of long-term commercial debt to 17 highly indebted countries is estimated to have increased from $17 billion in 1985 to $21 billion in 1989; 4/

(d) The macroeconomic and financial situation of debtor countries remains very sensitive to external shocks. Fragility is reflected in the comparison of the interest rate on the outstanding debt with the rate of increase of exports of goods and services. The logic of that criterion is that the rate of interest represents the amount of additional debt that has to be taken on to pay annual interest service. If export growth, in percentage terms, equals at least the interest rate, a country can increase its debt while stabilizing its interest to export ratio. The real interest burden, measured by the nominal interest costs deflated by the rate of change in the index of export prices of developing countries, increased substantially owing to a combination of high interest rates and a decline in export prices over the period 1981-1985. Though average external interest rate declined to about 9 per cent in 1988-1990 from more than 13 per cent during 1982, export growth has been unable to improve interest-to-export ratios. 5/

Notwithstanding these qualifications, there has been a significant debt reduction, as noted above. To some extent, this has been facilitated by regulatory changes in creditor countries. The following chapter reviews those changes and their implications for the participation of transnational banks in future debt reduction/cash-flow.

II. ACCOUNTING, REGULATORY AND TAX ADJUSTMENTS IN CREDITOR COUNTRIES

5. From the point of view of participating in debt-reduction efforts or reducing the cash-flow problem arising out of debt-servicing needs, regulatory regimes are important because they determine the impact of financial transactions on a commercial bank's profit-and-loss account as well on its capital position. Other things being equal, a bank will strive to maximize its profit while minimizing capital and reserve needs, so as to limit the funding costs of assets. The discussion in this chapter focuses on three major elements of regulatory regimes: capital adequacy requirements, the treatment of loan-loss provisions and the treatment of debt-restructuring instruments.

A. Risk-weighted capital adequacy guidelines

6. In July 1988, the members of the Committee on Banking Regulations and Supervisory Practices of the Bank for International Settlements agreed on a framework for assessing capital adequacy and for setting minimum capital/asset ratios by the end of 1992. In addition, the so-called "Cooke Committee" adopted a definition of a dual structure for bank capital - namely, core, or tier 1, capital, consisting of equity capital and disclosed reserves, and supplementary, or tier 2, capital comprising undisclosed reserves, asset revaluation reserves, subordinated term debt and general loss reserves. The Committee also limited inclusion of

general loan-loss reserves in capital in amounts up to 1.25 per cent of risk assets, while specific reserves were excluded. Finally, the Committee established risk-weighting factors in order to define capital targets. The main impact of risk-based capital rules is to make bankers more selective in the use of risk-based capital and impose drastic asset portfolio rebalancing decisions. As a result of the new capital targets, banks can either mobilize capital, reduce assets, or restructure the balance sheet, depending on various risk factors.

7. Banks have to reach a minimum 7.25 per cent target ratio of capital to risk-weighted assets by the end of 1990 and a ratio of 8 per cent by the end of 1992, of which the core capital element should be at least 4 per cent. In order to evaluate the bank capital adequacy, five different categories of assets are assigned weights according to their perceived riskiness. Each asset type is assigned a weight of 0 per cent, 10 per cent, 20 per cent and 50 per cent or 100 per cent to reflect its risk characteristics. By this method, higher risk assets will demand higher levels of capital support. For example, claims on developing countries' central Governments that are denominated in local currency receive a 0 per cent risk weight. Short-term loans to developing countries and claims guaranteed or collateralized by the international financial institutions receive a 20 per cent risk weight. All other claims receive a 100 per cent risk weight.

8. The risk-weighted capital rules are likely to have greater effect on the participation of transnational banks from France, Japan and the United States, as explained below. These rules should not pose any major problems for the banks from other creditor countries, as they are well capitalized.

1. France

9. In France, commercial banks have taken measures to meet the capital requirements. In particular, French banks have increased general loan-loss reserves in order to increase tier-2 capital elements. However, the inclusion of reserves in regulatory capital is only a temporary substitute for equity for French banks owing to the upcoming limitation of reserve inclusion in capital to 1.25 per cent of risk assets at the end of 1992, as noted above. Regarding new money transactions, French banks face the additional constraint of reserving incremental exposure at the same level as existing developing country assets. As a result, commercial banks are very reluctant to participate in new money packages and have delayed the finalization of loan agreements on several occasions. Regarding debt-reduction transactions, any discount leads to an accounting loss to be charged against reserves. The inclusion of reserves in capital, in turn, leads to a capital loss. Other things being equal, French banks, therefore, tend to oppose debt-reduction transactions and prefer debt-servicing reductions through reduced interest par bonds.

2. Japan

10. The implementation of risk-adjusted capital rules based on the guidelines will have a significant impact on the Japanese banks, which will need to alter substantially the size and composition of their capital base and restructure their balance sheets. The Ministry of Finance chose a liberal interpretation of the rules in April 1988 to the benefit of the Japanese banks. In particular, holdings of capital instruments of other banks will not be deducted from the computation of the holder's regulatory capital. Until the recent stock market plunge in Tokyo, banks were able to rely on substantial "hidden reserves" owing to the difference between book and market values. Japanese banks may count as capital 45 per cent of the value of the unrealized gains on security holdings. Traditionally, Japanese banks possess a large volume of tier-2 capital, resulting from unrealized gains in their equity portfolio. The sharp drop in Japanese equities and bonds during 1990, coupled with the relative decline in the yen value, makes it more difficult to meet the capital rules. In addition, the rise in interest rates has trimmed operating profits severely, thereby making it more difficult to boost capital.

11. Growing concerns regarding the profitability and domestic assets base of banks led the United States credit agency Moody's to put several Japanese banking institutions on its credit review list in September 1990, following the downgrading of the Dai-Ichi Kangyo and Fuji Bank. In November 1990, Moody's downgraded the Sumitomo Bank, the world's second-largest bank, as well as the other large Japanese banks - namely, Mitsubishi, Tokai and the Long-Term Credit Bank. The new emphasis on assets with favourable risk weighting, such as mortgage loans and government bonds, will lead Japanese banks to be more reluctant to participate in new money operations.

12. Despite steady increases in loan-loss reserves, the Japanese banks' coverage ratio remains below the level achieved in other creditor countries and below the interim capital adequacy requirement of 7.25 per cent. The relatively weak capital position of Japanese banks is likely to lead to larger developing countries' asset sales on the secondary markets. Thus, Japanese banks will be more reluctant to participate in new money operations.

3. United States of America

13. In the United States, transnational banks face the triple constraint of an ongoing erosion in the value of developing country claims, as reflected in declining prices in the secondary markets; deteriorating asset quality in real estate portfolios and loans for highly leveraged transactions; and interim capital adequacy targets at the end of 1990. United States banks have resorted to a range of modalities to strengthen their capital ratios, including increasing reserves, raising equity and decreasing assets. Owing to the inclusion of general loan-loss reserves in regulatory capital in the United States, banks have added about $8 billion to long-term developing country loan reserves during the first half of 1990. In addition, a combination of net charge-offs, allocated transfer risk reserves and loan sales have led to a sharp reduction in the ratio of developing country loans to total assets and to capital. United States banks are in the

process of restructuring the composition of their portfolios in order to take full advantage of the risk-weighted guidelines. As a result, their total outstanding developing country claims dropped to $79 billion at the end of 1989, compared with $93 billion a year earlier.

14. The equity positions of the United States money-centre banks have also improved significantly during 1989, with close to $2 billion in new equity issues by Chase, Chemical and Manufacturers Hanover. As a result, the ability of the United States banks to withstand further loss potential from developing country loans has increased. Most of the United States regional banks are now fully reserved against developing country loans. In addition, banks with small exposures sold large quantities of developing country assets on the secondary markets during 1986-1989. Regarding the large United States banks, boosting reserves against developing country loans and raising new equity tend to increase their inertia in participating in concerted debt-restructuring operations. However, money-centre banks present a large diversity regarding their ability to raise new capital and increase reserves. The combination of growing non-performing loans of domestic corporate clients and of the real estate market severely hurt profitability ratios. In particular, the profits of Citibank and Chase dropped during the third quarter of 1990, leading to a sharp decline in their stock values. For the United States banking industry as a whole, increased reserves, stronger capital ratios and declining developing country claims make banks increasingly reluctant to participate in new money transactions for developing countries as well as in debt-reduction schemes.

B. Treatment of loan-loss reserves

1. An overview of regulations concerning reserves

15. European banks initiated a first round of reserving against developing country bank claims as early as 1983 and 1984, under requirements of national banking supervision authorities. Tax incentives were provided to alleviate the cost of provisioning. A second round of reserving took place in the United States, when Citibank decided to boost loan-loss reserves in May 1987. All United States money-centre banks and the large United Kingdom clearing banks followed suit, owing to strong competitive pressure. A third phase of provisioning occurred during late 1987 and early 1988, when United States regional banking institutions initiated a very aggressive reserving policy, coupled with large sales of developing countries' assets. A last round of reserving took place after the announcement of the Brady initiative when United States money-centre banks decided to further strengthen reserves against developing country debt to about 50 per cent in the fall of 1989. Since then, banks such as Morgan and Bankers Trust raised their reserve level close to or up to 100 per cent of loans to developing countries. Citibank's reserve level, however, remains around 35 per cent of its exposure to developing countries.

16. Reserve levels are influenced by the treatment of loan-loss reserve in national regulatory regimes concerning whether the provisions are included in regulatory capital and how these are treated for tax purpose. Thus, in France and

the United States, country risk reserves are included in regulatory capital (in the tier-2 elements). In Japan, reserves are included in capital though in limited and carefully monitored amounts. In all other countries belonging to Organisation for Economic Co-operation and Development (OECD), loan-loss reserves against developing countries' debt are excluded from regulatory capital.

17. The tax treatment of loan-loss reserves has also an impact on portfolio management. In countries such as Canada, France, Germany and the United Kingdom, general loan-loss reserves are tax deductible. This encourages banks to reorganize capital base through provisioning rather than by selling their assets.

18. In Japan, the country risk reserves are tax deductible in an amount of 1 per cent. In the United States, loan-loss provisions are not tax deductible; only realized losses may be deducted. As actual charge-offs occur, taxes may be reduced, providing the opportunity to replenish reserves without additional charges against net income. In particular, specific mandatory reserves are tax deductible. A summary picture of regulations concerning loan-loss reserves is presented in table 2.

Table 2. Tax and accounting treatment of loan-loss reserves

Country	Provision levels (percentage)	Capital inclusion a/	Tax deduction a/
Canada	45	No	Yes (45)
France	58	Yes	Yes (60)
Germany	50-80	No	Yes
Japan	40	Yes (39)	Yes (1)
United Kingdom	65	No	Yes (50)
United States			
Regional banks	75	Yes	No
Money-centre banks	50	Yes	No

Source: Michel H. Bouchet, "Transnational banks and external indebtedness of developing countries", paper prepared for the United Nations Commission on Transnational Corporations, November 1990.

a/ Figures in parentheses are percentages.

2. Implications for debt-reduction negotiations

19. To the extent banks are allowed to recognize tax losses without disposing of their loans, they have little incentive to participate in voluntary debt-reduction operations. To the extent reserves are both tax deductible and included in regulatory capital, banks would have still less incentives to participate in debt-reduction schemes owing to the resulting upfront capital loss.

20. Commercial banks tend to choose between free riding, new money, and/or debt-reduction transactions, depending on a wide range of constraints and motivations, including long-term business interests, amount of exposure, corporate client networks and capital ratios. Other things being equal, large loan-loss reserves tend to make transnational banks more reluctant to participate in new money and debt-reduction transactions. Banks can more easily withstand further loss potential in developing country loans. Tax credits from reserves represent an additional strength to the banks. In Japan and the United States, however, banks do not fully capture these tax benefits, which require the losses to be realized. Accounting and tax benefits for the creation of loan-loss reserves will influence not only the amount of reserves but also the willingness and the ability of transnational banks to participate in debt-restructuring negotiations.

21. Where commercial banks are allowed to include reserves in capital (as in France and the United States), they will be reluctant to enter debt-reduction schemes owing to the related upfront capital loss. Buybacks and discount bonds will thus probably meet strong opposition from the creditor banks. These banks will tend to prefer par bonds with temporary reduced interest rates in order to stretch the accounting loss in the income statement over the life of the loan. Commercial banks which must reserve against new money credits (e.g., in France) will face an additional cost compared to banks which have the discretion of increasing or maintaining reserves at existing levels. Finally, banks which benefit from very limited tax deductions on loan-loss reserves (e.g., in Japan) will prefer selling discounted developing country claims in order to shrink their new money base and improve asset to capital ratios.

C. Treatment of debt-restructuring instruments

22. The preceding section has shown that transnational banks have made large provisions against claims on developing countries. In part, such high provisions resulted from accounting and tax incentive to strengthen loan-loss reserves, prompted by the desire to protect banks from overexposure. However, this is fraught with a perverse implication for debt reduction because high provisions encourage banks' inertia with respect to new money loans and/or participation in debt reduction. In consequence, regulatory provisions were modified by several creditor countries to facilitate the implementation of the new official strategy of debt reduction. The scope of the present report does not permit a comprehensive discussion of the various regulatory adjustments in different creditor countries. The salient features of these adjustments in selected creditor countries and their implications for future debt-restructuring agreements are described below.

1. France

23. The Banking Commission of the Banque de France stipulated that French banks should adopt a reserve level at least equal to the average provision level of the French banking community, currently about 55 per cent. Such an average level is considered like a minimum level. Regarding the accounting treatment of provisions held against debt-restructuring bonds, on 30 October 1989 the Banque de France stipulated that discount bonds do not lead to a drop in reserves as long as a bank's reserve level is below the banking community's average level. Likewise, new money credits do not require incremental provisions as long as a bank's reserve level is equal to or above the banking community's average level.

24. In November 1989, the Banque de France's Governor declared, however, that banks may make reserves against new money loans even if it implies reserves above the average level. New debt-restructuring instruments do not require additional loan-loss provisions as long as there is no major country risk deterioration. Par bonds do not lead to any decline in provisions, hence involve no upfront capital loss. Initially, the securities are recorded in the "transaction portfolio", where sales/purchases give rise to profits/losses which are lumped together in the end-of-year profit and loss statement, resulting in an adjustment in provisions. Securities held in the transaction portfolio must be marked to market. Banks may record the bonds at a later stage in the "investment portfolio" where bonds are kept until maturity and do not require provisions as long as the payment of principal is guaranteed. The value of the bonds at year-end is the lower of either the acquisition price or the market price. French banks have two years to decide where to hold the securities.

25. Debt-to-equity swaps, for accounting purposes, constitute a disposal of assets (so-called "cession"), with a resulting decline in developing country claim portfolio and a corresponding increase in equity participation portfolio. The tax treatment of equity holdings currently is less favourable than the treatment of loan-loss reserves.

26. Regarding the treatment of Mexico's debt-restructuring agreement, the Director of the Treasury agreed to make an exception to the normal tax rule in October 1989. Normally, collateralized debt-exchange offers should lead to recapturing provisions in the income statement. New provisions against securities would then be taxed at 19 per cent rate, compared to 34 per cent.

27. Regarding discount bonds whose principal is collateralized, the Treasury stipulated that excess provisions, i.e., above the discount or loss level, would be gradually recaptured and taxed over the life of the new instruments. In the case of Mexico's discount bonds, thus, provisions would be linearly recaptured over 30 years. In August 1990, the Director of the Treasury agreed that a similar tax treatment be applied to Venezuela's debt-restructuring agreement regarding collateralized bonds. Regarding par bonds, overall existing provisions must be gradually recaptured and taxed accordingly. Regarding new money credits, additional country risk provisions are established so as to reach an average level that is considered adequate by the Banque de France. Incremental provisions are tax deductible up to the maximum limit of 60 per cent.

28. The combination of tax deductibility and capital inclusion of reserves has proved to be a powerful incentive for constituting large and growing provisions against developing country exposure. Current reserve levels of the three largest banks stand at close to 60 per cent - that is, the maximum authorized level for tax deductibility. Within this global limit, however, bank management has the discretion of allocating loan-loss reserves in accordance with country risk assessment - that is, as long as the average reserves stand at 60 per cent. French banks' substantial loan-loss reserves have strengthened capitalization ratios due to the capital inclusion of reserves. However, large reserves might constitute disincentives to participate in new money and debt-reduction exercises for two reasons.

29. First, new money loans are taxed by incremental reserves and contaminated by secondary market discounts. According to French bank regulatory authorities, banks have to provision new money at the same level as existing exposure. The Banque de France does not recognize the implicit seniority of new loans vis-à-vis existing exposure. Refinancing arrangements, therefore, require similar ratios of loan-loss reserves as old claims. As a result, French banks will be reluctant to be "new money banks" in debt-restructuring and refinancing agreements.

30. Secondly, French banks face tax constraints regarding the debt-exchange offers that involve swapping existing loans for new bonds. In such an exchange, provisions on existing claims have to be recaptured in income and taxed accordingly. In addition, new provisions must be constituted against the bonds, though at a lower tax rate. The implicit seniority of bonds compared to loans, therefore, is not an element of much significance for inducing French banks to participate in new money exercises.

31. In a menu of debt-restructuring options, French banks might favour reduced-interest rate loans which will not materialize in capital losses but rather in accounting losses over the life of the new financial instrument. Thus, in the 1990 Mexico Debt Exchange Offer, Credit Lyonnais chose the par bond option for about two thirds of its exposure. Likewise, Indosuez opted for the par bond in order to stretch the accounting loss throughout the 30-year life of the instrument. Choosing discount bonds would have affected the capital ratio target, owing to the reserve inclusion in regulatory capital. Société Generale also opted for par bonds because the fixed rate and the stability of reserves were perceived as two major advantages compared to discount bonds and new money.

32. Several modifications in tax and accounting regimes of debt-restructuring transactions and new money agreements could facilitate the participation of French banks in debt-restructuring schemes. A differentiation between old and new claims, for accounting purposes, would encourage banks to join new money agreements. In addition, adjustments in the tax treatment of securities would remove current obstacles for swapping existing loans for bonds. Currently, provisions on securities receive less generous tax deductibility than loans. The decision of the Ministry of Finance to grant an exceptional treatment to securities issued by Mexico in the course of the 1990 Debt Exchange Offer has left some questions unanswered. In particular, uncertainty remains regarding the accounting treatment of Mexico's bonds in the year-end balance sheet. In normal accounting terms, bonds

should be registered on the basis of their market prices. Should a gap appear between existing provisions and market value, French banks do not currently know what will be the guidelines provided by the Banking Commission.

2. Japan

33. The Japanese authorities have limited the banks' ability to recognize tax losses on developing country loans. Accordingly, banks have incentives to participate in debt-reduction transactions in order to accelerate tax-loss realization. In addition, Japanese banks' high profitability and large (though rapidly eroding) hidden reserves might provide further incentives to accept sharing secondary market discounts with debtor countries. The ongoing appreciation of the yen vis-à-vis the dollar has also improved the developing country assets of Japanese banks to their reserve ratios by reducing developing country exposure as a percentage of equity and total assets. On a case-by-case basis, the Ministry of Finance has encouraged banks to participate in debt-restructuring agreements by allowing them to recognize losses for both accounting and tax purposes.

34. In the case of Mexico's Aztec bonds in March 1988, the banks were able to deduct losses from their tax liabilities and to avoid contamination of their portfolios regarding the portion of the loans not tendered. Thus, Japanese banks were allowed to sell their loans at a discount without revaluing the rest of their portfolios at the same discount, whether or not bank claims were tendered. In the case of buybacks in Chile and in Bolivia, the Ministry of Finance allowed a recognition of tax losses equal to the difference between the book value of the original loan and the value of the cash received.

35. In October 1989, the Banking Bureau and the International Bureau of the Ministry of Finance, in consultation with the Tax Bureau and the Securities Bureau, issued guidance regarding Mexico's par and discount bonds. According to these guidelines the Mexican bonds will be listed at the Luxembourg stock exchange. The acquisition price of the bonds shall be the first traded price at the exchange. If a bond is not traded for the time being, the indication price shall be the bond price. Moreover, the price difference between the original book value of the loan before being swapped for the Mexican bond and the acquisition value of the loan is recognized as loss for both tax and accounting purposes. In addition, the bonds received must be revalued annually in accordance with the banks' normal accounting method for listed securities. Thus, any subsequent drop in the market value of the listed bonds will lead to a loss for tax and accounting purposes. In the 1990 Mexico's restructuring package, Japanese banks' options were strongly in favour of discount bonds.

36. Regarding debt-to-equity swaps, the Ministry of Finance has liberalized regulations for secondary market transactions. Permission from the Ministry is still required for loan sales. Though banks may not participate directly in swaps, they may sell discounted loans to Japanese corporations for debt-to-equity conversion transactions. A joint factoring company, based in the Cayman Island, has been set up by 28 commercial banks for that purpose. The Ministry has provided tax incentives to encourage debt swaps in a subsidiary's capital.

37. Japan's Ministry of Finance has taken a case-by-case approach to voluntary debt and debt-service reduction. The Ministry has not disclosed the list of debtor countries for which loan-loss reserves must be created, though about 45 debtor countries reportedly are on the current list. The recognition of loan-losses results from specific negotiations between commercial banks and the regulatory authorities. On several occasions, the Ministry of Finance has provided the banks with flexible guidance for entering debt buybacks and debt conversion schemes, in particular in the cases of Bolivia, Chile, Mexico and Venezuela. The Ministry has also modified regulations for encouraging debt-to-equity swap transactions. Finally, the Cayman Island-based factoring company can be used as a channel for discounted developing country asset sales by Japanese banks, although within limits set by the Ministry. Remaining constraints on debt-reduction transactions stem from the differentiated tax and accounting treatment of discount and par bonds. Under current guidelines, interest-rate reductions would not normally result in the recognition of tax or accounting losses, while principal reductions would be more likely to lead to loss recognition.

3. United Kingdom of Great Britain and Northern Ireland

38. In February 1988, the Bank of England specified the accounting and regulatory treatment of Mexico's auction of bonds to be tendered at a discount. The Bank of England decided to treat the bonds as Mexican risk as to both principal and interest even though principal repayment on the 20-year securities was to be collateralized by a special issue of non-marketable securities of the Government of the United States. Bonds that were held for long-term investment would be treated like existing loans with provisions driven by the matrix of factors established by the Bank of England to determine the adequate level of loan-loss provisions. The three categories of factors are: the borrower's inability or unwillingness to meet its debt-servicing obligations; the nature of debt-repayment difficulties and the extent of the country's financial problems; and the likelihood of repayment problems either persisting or arising in the future. In January 1990, the Bank of England revised the matrix which provides the framework for assessing provisions against claims on developing countries and recommended higher levels of provisions.

39. The Bank of England specified the treatment of Mexico's debt-restructuring instruments for the 1990 financing package. The discount bonds should be placed on bank books at face value, that is, at 65 per cent of the original face value of the bank loans. The difference between the booked and the original face value should be charged to provisions. An additional charge to income would only be required if the loss exceeds the original level of provisions. In addition, the supervisory authorities stated that no additional provisions would be required against the discount bonds, unless Mexico's economic and financial situation deteriorates in the future. In the case of par bonds, banks may record the bond at its face value and no additional provisions are required unless there is a further deterioration in Mexican risk.

40. The Inland Revenue has specified that developing country loan-loss reserves are tax deductible on the basis of the estimated amount of losses. By contrast, securities (including bonds) are normally taxed on a realization basis. Thus,

losses on such securities would not be recognized for tax purposes until the assets are sold.

41. In the case of Mexico's 1990 debt restructuring, the Inland Revenue stated that discount bonds would be booked at face value and that difference between the value of the original loan (that is, 100 per cent) and the value of the bonds (that is, 65 per cent) would be deducted. Par bonds should be booked at face value, less a provision calculated on the basis of the net present value of the funding cost over the life of the bond, that is, 30 years.

42. Because loan-loss provisions are not included in regulatory capital, United Kingdom banks do not face an upfront capital loss in exchanging existing claims for discount bonds nor for cash in discounted repurchase operations. Provisions are tax deductible within limits set by the Inland Revenue. Banks face limitations on allowable tax losses in discounted debt exchanges in the inter-bank secondary market unless they participate in debt buyback operations for the benefit of debtor countries. For accounting purposes, the regulatory authorities do not differentiate between new money loans and existing exposure. As a result, United Kingdom banks must establish incremental loan-loss provisions on new loans on the basis of the matrix. In addition, the matrix does not differentiate risk according to the implicit "seniority" and servicing track record of particular financial instruments, with the exception of short-term trade lines. New money bonds, therefore, do not receive any special status. Finally, the matrix does not facilitate developing countries' return to market access since it provides a large negative score to countries which have rescheduled at any time since January 1983. Adjustments in the matrix with a view to differentiating debtor countries regarding future ability to service debt-payment obligations and not purely past behaviour would clearly encourage new money credits.

4. United States of America

43. An important part of the 1990 agreement between the banks and Mexico provided that the loan-to-bond conversion would take the form of a debt-exchange offer. Neither type of bond would be subject to the sharing clauses that are standard in most syndicated loan agreements. The agreement provided for a comprehensive rescheduling of all eligible medium- and long-term bank debt. Accordingly, debt held by creditors participating in the financing package would not be subject to pro rata sharing clauses with debt held by banks not participating. In that sense, the 1990 pact created a "legal novation" with respect to previous agreements between Mexico and the commercial bank creditors.

44. For the United States banks, exchanging loans for discount bonds would normally lead to a reserve decline equal to the difference between the face value of the debt and the discount, hence an upfront capital loss owing to the inclusion of reserves in regulatory capital. Thus, in the case of Mexico's 1988 "Aztec bonds", United States banks were required by the Security and Exchange Commission to fair value the bonds received in the auction and to write down all loans offered for exchange to the tender price, implying a substantial capital loss for banks participating in the exchange transaction.

45. For accounting purpose, the Federal Reserve Board and the Security and Exchange Commission accepted to consider Mexico's later debt restructuring as an "exchange offer" under the framework of Financial Accounting Standards Board Statement No. 15 (or FASB 15). In particular, it was stipulated that where a transaction can be categorized as a "troubled debt restructuring" under FASB 15, banks need not necessarily recognize a capital loss upon participating in voluntary debt reduction. FASB 15 defines a "troubled debt restructuring" as a restructuring of bank claims in which the creditor grants a concession to the debtor owing to the debtor's financial difficulties. The concession may make the form of an interest rate reduction, the extension of maturity dates, a reduction of principal, or debt-exchange offers, including debt-equity swaps.

46. The Security and Exchange Commission recommended the application of FASB 15 as appropriate accounting treatment of Mexico's debt restructuring for both discount and par bonds, because both transactions involve concessions granted due to the debtor's financial difficulties. In particular, the Security and Exchange Commission stipulated that a loss is recognized only if the total future undiscounted cash receipts under the new terms of the loan, including both principal and interest payments, are less than the book value of the loan. Because of the 30-year collateral of the bonds' principal and a positive nominal interest rate, such criteria were met by both the par and discount bonds.

47. In the United States, loan losses associated with sovereign risk credits are permitted full tax deductions only when loans are sold or when a country's loans have been deemed value impaired and an allocated transfer risk reserve has been mandated by regulators. The effective tax deductibility of losses depends on two factors.

48. First, tax loss is granted only if a transaction triggers a realization of the loss. Thus, the cash sale of an asset, the partial or complete charge-off, or an exchange for a different asset will realize a loss. Secondly, a bank should have available taxable income against which the loss can be offset to achieve either a reduction in taxes currently payable or a refund of taxes previously paid. If the realized loss in a given year exceeds taxable income, banks can "carry back" the resulting net loss against tax returns up to 10 years prior or "carry over" the loss against tax returns 5 years ahead and obtain refunds.

49. The 1990 Mexican Financing Package raised a number of tax issues related to par and discount bonds. The Internal Revenue Service issued a ruling (IRS Revenue Rule 89-122) stating that both bonds represent a material change in the terms of the obligations which lead to an exchange for tax purposes. If the bond is "publicly traded" within the meaning of the Internal Revenue Code, then it must be recorded at its fair value for tax purposes. Should the bond not be "publicly traded", it must be recorded at its issue price which is the lesser of the face amount of the new instrument or the present value of the debt instrument using the "applicable federal rate" as the discount rate.

50. The Internal Revenue Service gave mixed signals to the United States banking industry regarding support to the debt strategy. In May 1989, the Internal Revenue Service announced limits on the tax breaks banks can get on losses on developing

country loans. Under this ruling, foreign loan losses are only deductible against foreign loan income. Until then, banks were allowed to reduce their taxable income by subtracting foreign loan losses from both foreign and domestic loan income.

51. The tax treatment of debt-equity swap transactions has been specified by the IRS ruling 87-124. The tax rule differentiates between three types of transactions for tax purposes:

(a) In a discounted sale on the secondary market to a private investor, a bank can recognize a tax loss equal to the difference between the face value of the asset and the amount received from the purchaser;

(b) In a debt-conversion transaction in which a bank directly tenders an obligation to the debtor country's central bank, the bank may recognize a loss equal to the difference between the fair market value of the equity investment and the face value of the assets;

(c) In a debt-conversion transaction for the benefit of a charitable organization, a bank can realize a loss on the exchange of the debt equal to the difference between the face value and the fair market value of the local currency proceeds of the conversion. In addition, the bank is entitled to tax relief admissible to a charitable contribution which will be considered to be equal to the fair market value of the conversion.

52. To the extent that a United States bank seeks to acquire for its own account an equity interest in a company located in a debtor country, regulations restrict the extent of the bank's ownership interest in the local enterprise. In particular, banks are subject to the restrictions on equity investments contained in Regulation K issued by the Federal Reserve Board. Regulation K limits banks to investments and activities outside the United States that are "of a banking or financial nature". The Board has relaxed the restrictions of Regulation K in the context of debt-equity swap transactions in developing countries. Prior to these amendments, the regulation posed a significant obstacle to United States banks acquiring large equity positions in foreign non-financial companies.

53. In recent years, the Board amended Regulation K twice. The first amendment in August 1987 permitted United States banking organizations to acquire up to 100 per cent of the shares of a foreign non-financial company under several conditions:

(a) The company is acquired from a foreign Government;

(b) The country has restructured its sovereign debt obligations to foreign creditors since 1980;

(c) The ownership interest in the company is divested no later than five years from the date of acquisition;

(d) The investment is held through a bank holding company.

Effective February 1988, the Board further amended Regulation K to permit banking organizations to make investments up to 40 per cent of the shares of any private sector company in a heavily indebted country through debt-equity swaps.

54. On 1 May 1985, the Comptroller of the Currency issued a circular governing the accounting treatment of capitalization of interest on loans. Capitalized interest is defined as uncollected interest which is added to unpaid principal in accordance with the contractual loan agreement. The circular provides that interest capitalization would not be permitted if loans are classified by the examiners as loss, doubtful, value impaired or non-accrual.

55. As a result of more flexible accounting and tax guidelines, United States banks may capture tax benefits through loss realization, thereby facing a more favourable regulatory environment for implementing debt-conversion transactions, such as debt-to-equity, debt-for-nature and debt-for-exports swaps.

56. However, the new tax ruling restricts banks from deducting foreign credit losses from domestic loan income. This ruling in effect reduces the amount of foreign tax credits available in a given year to banks that write down foreign loans. The reaction of United States banks was that the Internal Revenue Service ruling would make banks still more reluctant to participate in the Brady initiative.

57. Besides, the strict guidelines of United States regulators for interest capitalization prevent United States banks from capitalizing uncollected interest payments in lieu of new money. As a result, interest capitalization in debt-restructuring agreements has become a less viable option for United States commercial bank creditors.

III. SUGGESTIONS FOR FURTHER ACTION

58. As noted before, the substantial reduction of the debt of developing countries during the past few years has been facilitated by flexible regulations regarding debt exchange, discounted sales and debt-equity transaction. However, the need for further modifications remains. Some suggestions have been offered in the context of regulatory changes in specific creditor countries discussed in the preceding chapter. Additional suggestions for further reforms are described below.

A. Risk-weighted capital guidelines

59. The new international capital guidelines of the Bank for International Settlements will have a major impact on transnational banks' asset portfolio management with implications on developing countries' access to capital markets and debt reduction, for several reasons:

(a) Even for those countries which have maintained access to the international capital markets, the new guidelines make bank lending more expensive in terms of capital backup, since a 100 per cent risk weight is applied to all long-term claims on all developing debtor countries. The provision of new money to

developing countries is, therefore, more expensive. The assignment of uniform 100 per cent risk weight to all developing countries deserves review;

(b) The guidelines do not differentiate between developing countries according to credit-worthiness criteria. Thus, all developing countries are included in the same category irrespective of their past performance record. This implies higher costs of funds because bank creditors will require higher spreads to offset the relatively higher risk weight. A distinction between debt-restructuring and debt-refinancing countries would preserve market access for those countries which have kept servicing their external liabilities;

(c) The new capital guidelines impose a limited inclusion of loan-loss reserves in capital by the end of 1992. While specific reserves are excluded from regulatory capital, general reserves may be included in amounts up to 1.25 per cent of risk assets. For capital weak banks, this limited inclusion will mean that they have to improve their capitalization through additional equity, sales of assets, or portfolio restructuring. On the other hand, for banks which include reserves in capital without limitation, as in France and United States, capital inclusion tends to make banks unwilling to agree on discounted debt-exchange offers owing to the related upfront capital loss. The rationale for including general loan-loss reserves in regulatory capital is that non-allocated provisions amount to quasi-capital which can provide a cushion against unexpected loan losses. Where reserves are included in capital, regulators might support timely debt-reduction agreements by removing the capital inclusion of reserves in case of protracted debt negotiations.

B. Tax deductibility of discounted asset sales

60. With large and growing loan-loss reserves against developing country exposure, transnational banks can more easily withstand protracted arrears. Instead of providing new money credits or participating in discounted operations, banks might prefer holding their reserved assets or entering portfolio rebalancing transactions in the interbank market.

61. Regulators might provide additional incentives to commercial banks for participating in debt-reduction operations for the benefit of developing countries with official support. Thus, in the spring of 1990, the United Kingdom's tax authorities decided to provide full tax relief only for developing country asset sale transactions which lead to actual debt relief for the debtor countries. A full realization of the loss for tax purposes would not be granted for inter-bank developing country asset sales on the secondary market of commercial bank claims. This would allow debtor countries to share the discount with their commercial bank creditors. Similar decisions by other creditor countries could encourage a greater participation of transnational banks in providing additional debt relief to debtor countries.

C. Distinction between purposes of credit

62. The appropriate level of country risk provisions should be related to the relative riskiness of an asset and its degree of ultimate collectibility. In practice, transnational banks determine their provisioning level against their total developing country exposure, whatever the nature of the claims. In France, for instance, banks determine reserve levels against both long- and short-term claims, including trade credits which are normally serviced. Bank regulators might isolate revolving trade lines and specific-purpose financing instruments from doubtful loans in order to preserve debtor countries' access to voluntary financing flows.

63. Similarly, bank regulators do not differentiate new money loans from existing developing country assets for accounting purposes. For example, in Canada and in France, banks are expected to build additional tax deductible reserves against new money credits to developing countries. New money credits could be considered as requiring less provisions than existing assets. Despite the limited tax deductibility of reserves against new money credits, provisions tend to make new credits more expensive and hence discourage banks from participating in cash-flow relief transactions.

D. Accounting penalties for free-riding banks

64. In new money and debt-reduction negotiations, a crucial issue is the level of bank participation in a debt agreement. Following completion of an agreement between a country and its bank steering committee, a telex is sent to the entire community of bank creditors for approval. Small exposure banks which do not have long-term business interests in a country and which have large provisions, tend to be reluctant to increase exposure or to accept income or capital losses. Accordingly, refinancing agreements can be delayed for several months because of a few recalcitrant banks. Thus, in the case of Columbia's 1988 refinancing agreement, only 112 out of about 175 creditor banks signed the new agreement, thereby forcing large banks to increase their share so as to offset the exit of small banks.

65. Bank regulators could stimulate participation in debt-relief exercises by requiring non-participating banks to increase non-tax deductible reserves against developing country claims.

E. Coordination

66. Regulatory differences among creditor countries, some of which have been detailed in the preceding chapter, make it a formidable task for debtor countries to formulate a debt-reduction package that has a similar impact on all creditor banks. This imposes a severe constraint on securing a consensus on any package and makes negotiations a protracted and time-consuming process. Hence, the need for closer coordination among creditor countries in formulating regulations that can facilitate debt reduction.

CONCLUDING OBSERVATIONS

67. The earlier debt strategy associated with what is known as the Baker Plan was essentially centred on the provision of additional money. The implicit stipulation was that the debt problem was primarily one of illiquidity and the provision of new money could buy the time needed to get over the temporary crisis. But the prolonged nature of the problem, coupled with the fact that new money contributions by transnational banks did not materialize, brought about a major shift in the debt strategy in favour of debt reduction.

68. The present report has shown that, notwithstanding some significant debt reduction, facilitated by regulatory adjustments in creditor countries, there is no reason to be complacent about the debt problem. Against this background, the report has examined the implications of regulatory modifications for future debt-reduction efforts with reference to selected creditor countries. The report has also identified some general areas which require regulatory authorities' urgent attention in order to facilitate further debt and/or cash-flow relief for the debtor countries.

69. The analysis in this report has shown that there are differences in the regulatory frameworks among different creditor countries giving rise to different incentives for their transnational banks to participate in debt reduction. It has not been possible to examine in any detail the differences in the extent of participation of banks from various creditor countries in debt-reduction measures in response to differential incentives. Further research in this direction could provide very useful insight regarding the impact of regulatory changes on transnational banks' participation in debt-reduction efforts.

70. It should also be emphasized that regulatory modifications are no more than enabling in nature. In other words, they can, if suitably formulated, generate a set of incentives for transnational banks to be more willing participants in debt-reduction/cash-flow relief transactions. But these would have to be supported by a greater commitment on the part of political authorities in creditor countries in order to ensure that their transnational banks respond vigorously to the incentives offered through regulatory adjustments.

Notes

1/ Official Records of the Economic and Social Council, 1990, Supplement No. 6 (E/1990/26).

2/ "Transnational banks and external indebtedness" (E/C.10/1990/11), p. 8.

3/ Michel H. Bouchet, "Transnational banks and external indebtedness of developing countries", paper prepared for the United Nations Commission on Transnational Corporations (1990), p. 9.

Notes (continued)

4/ World Bank, World Debt Tables 1989/90, vol. I (Washington, D.C., 1990), p. 13.

5/ Michel H. Bouchet, op. cit., p. 5.